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In the Supreme Court of the United States

OCTOBER TERM, 1966

No.

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

UNITED BENEFIT LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered on March 10, 1966, which affirmed the judgment of the district court entered on April 5, 1965.

OPINIONS BELOW

The opinion of the court of appeals (App. A, pp. 16-23, *infra*) is reported at 359 F. 2d 619. The oral

ruling, findings and conclusions of the district court (JA I 76-77, 105-107)[1] are unreported.

JURISDICTION

The judgment of the court of appeals was entered on March 10, 1966 (App. B, p. 24, *infra*). On June 9, 1966, the Chief Justice extended the Commission's time to file a petition for a writ of certiorari to July 8, 1966, and on July 7, 1966, Mr. Justice Stewart further extended the time for petitioning to August 8, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the "insurance" exemptions to the disclosure and regulatory provisions of the Securities Act of 1933 and the Investment Company Act of 1940 comprehend a "Flexible Fund Annuity" under which the value of the purchaser's interest during the accumulation period and the size of the annuity available at maturity depend upon the value of a portfolio of securities.

STATUTES INVOLVED

The relevant provisions of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*, and the Investment Company Act of 1940, 54 Stat.

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[1] "JA I" and "JA II" refer to Volumes I and II, respectively, of the Joint Appendix in the court of appeals. "PX" refers to the Commission's exhibits.

789, 15 U.S.C. 80a-1, *et seq.*, are set forth in Appendix C, *infra*, pp. 25-27.

STATEMENT

The Securities and Exchange Commission instituted this action in the United States District Court for the District of Columbia to enjoin respondent from offering and selling securities in violation of the registration requirements of Section 5 of the Securities Act of 1933 (15 U.S.C. 77e) and from engaging in activities enumerated in Section 7(b) of the Investment Company Act of 1940 (15 U.S.C. 80a-7(b)) without registering its "Flexible Fund" pursuant to Section 8 of that Act (15 U.S.C. 80a-8). At issue is the applicability of these statutes to respondent's "Flexible Fund Annuity" program, which may be briefly described as follows:

A purchaser of a "Flexible Fund Annuity" makes fixed periodic payments to respondent. Respondent undertakes to pool these amounts, after certain specified deductions for sales and administrative expenses,[2] with amounts received from other purchasers of such contracts in a separate account called the "Flexible Fund" or "Flexible Fund A" (PX 2, 3; JA II 3, 13).[3] The assets of the Flexible Fund are invested

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[2] Fifty percent of the first year's payments is deducted, 9½ percent is deducted in each of the following nine years, and 5 percent in each of the following years (PX 2, 3; JA II 3, 13).

[3] Special enabling legislation in Nebraska permits respondent to establish and administer such a separate account. The

by respondent in securities, consisting largely of common stocks (PX 3, 8B; JA II 12, 15, 70). The portfolio is administered by respondent, and securities are bought or sold in accordance with the investment judgment of its management (PX 2, 3; JA II 8, 15). Each month respondent computes the net asset value of the Flexible Fund,[4] and this in turn fixes the value of each investor's pro rata share (PX 2, 3; JA II 3, 13).

The purchaser continues making payments until a "maturity" date selected by him when he first enters into the contract (subject to subsequent change within certain limitations) (PX 2, 3; JA II 2, 4, 18, 19). At any time during this "pay-in" period, he has the option of surrendering his contract and receiving the accumulated value of his interest in the Fund. If he dies during this period, his beneficiary receives either the accumulated value of his interest or a refund of the total of his payments theretofore made, whichever is larger (PX 2; JA II 2, 3).

At maturity, the contract holder may elect to take his total accumulation in cash or to apply it to the purchase of an annuity under which he receives fixed

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statute permits income and gains or losses on such an account to be credited or charged to amounts allocated to it "without regard to the other income, gains, or losses of the company." Neb. Rev. Stat. § 44-310.06 (1963 Cum. Supp.).

[4] The Flexible Fund is reduced each month by a provision for "Company income taxes" and by approximately 1 percent per year in monthly charges for investment management costs and for the cost of fulfilling the respondent's mortality and "minimum cash value" guarantees (PX 2, 3; JA II 3, 13; JA I 98).

monthly payments for the remainder of his life. The size of these payments is determined by the value of the contract holder's pro rata interest in the segregated fund on the maturity date (PX 2; JA II 2, 5). Once the "pay-out" period begins, he no longer has an interest in the Flexible Fund and the annuity payments do not fluctuate with changes in the market value of the Fund's portfolio.

In addition, the contract contains a "minimum cash value" provision under which respondent guarantees that if the accumulated value of the contract holder's interest at the time he withdraws from the Fund, whether at or before maturity, is less than a certain minimum amount, respondent will make up the difference between the accumulated value and the specified minimum. This guaranteed minimum is computed in terms of a percent of "net premiums"—*i.e.*, the purchaser's gross payments minus deductions for sales and administrative expenses (see note 2, p. 3, *supra*). The guarantee, in effect, assures purchasers that a percentage of the "net premiums" invested by them in the Fund, ranging from 50 percent in the first year to 100 percent after ten years, will be available upon withdrawal, either to be taken in cash or to be applied to the purchase of a fixed-dollar annuity (PX 2; JA II 3).

At the conclusion of the Commission's evidence, respondent moved to dismiss the complaint on the ground that the "Flexible Fund Annuity" was "an insurance product" and was therefore exempt from the requirements of the Securities Act of 1933 and the

Investment Company Act of 1940 (JA I 103-104). The district court entered findings of fact, among which was the following (JA I 105):

> 5. Under the guaranteed minimum cash value provision in the FFA policy the defendant guarantees to the annuitant a fixed dollar equal monthly retirement income after the maturity date is reached which income cannot be outlived and the defendant thereby assumes the investment risk involved in that guarantee.

On the basis of this finding, the district court concluded that respondent had, within the meaning of this Court's decision in *Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co.*, 359 U.S. 65, assumed a sufficient share of the investment risk to qualify the contract as an "insurance product," and it dismissed the complaint (JA I 106-107).

The court of appeals affirmed, holding that "United has assumed not only a substantial part, but by far the major part, of the investment risk over the duration of the entire policy. The obligations of United under the FFA, unlike those of the variable annuity, are stated, in large part, in terms of guaranteed dollar amounts; there is a substantial and meaningful 'floor' to the FFA policy" (pp. 22-23, *infra*).

REASONS FOR GRANTING THE WRIT

In *Securities and Exchange Commission* v. *Variable Annuity Life Insurance Co. ("VALIC")*, 359 U.S. 65, this Court held that the purchaser of a variable annuity—*i.e.*, an annuity contract under which

the purchaser receives an interest that fluctuates in acordance with the market performance of a fund of securities—is entitled to the protections of the Securities Act of 1933 and the Investment Company Act of 1940, because such contracts are securities rather than "contracts of insurance." The contract involved in this case differs in certain respects from the variable annuity involved in *VALIC*, but its essential nature is the same. Both *VALIC* and this case concern a relationship in which the investor's return depends directly upon the investment performance of a managed pool of securities, and the need for the protections of the securities laws is as important here as in *VALIC*. The decision of the court of appeals that *VALIC* is inapplicable deprives that decision of much of its practical significance because insurance companies can readily provide the features which were deemed adequate here to render the contract an exempt "insurance product."

1. The Securities Act of 1933 requires full disclosure of the information necessary to enable the purchaser of a security intelligently to appraise the risks involved when he is asked to invest his funds in an enterprise managed by others. The Investment Company Act of 1940 provides additional protections, including safeguards to assure investor control over management and over investment policy, if the investment takes the form of a participation in a managed fund or pool of securities. The protections afforded by the securities laws were intended to apply whenever the investing public is asked to buy interests which place the purchaser in the position of directly

sharing the risk of the investment performance of a managed fund or pool of securities, and it was because such a relationship was not present in traditional insurance and annuity contracts that Congress enacted the insurance exemptions.

This Court has often noted that these statutes should be liberally construed to achieve their obvious purpose of protecting investors. The test for determining whether a contract is within the coverage of the securities laws must turn on "economic reality" so that "[t]he statutory policy of affording broad protection to investors [will] not be thwarted by unrealistic and irrelevant formulae." *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293, 298, 301. In construing exemptions from the registration requirements of the securities laws, "[t]he focus of inquiry should be on the need of the offerees for the protections afforded by registration." *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119, 127. See also *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 352-353.

Investor protection is as necessary here as it was in *VALIC* and as it is in the case of any open-end investment company, or mutual fund. Mutual funds commonly sell a substantial portion of their shares under periodic accumulation arrangements which are essentially identical to the terms on which the participations in respondent's Flexible Fund are sold. The shares sold under these periodic accumulation plans, like the interests acquired in the Flexible Fund, represent a proportional share of a portfolio of securi-

ties, largely common stocks. As with the plan involved here, the periodic accumulation plans provide for the payment by investors of specified sums of money at given intervals, and this money, after deduction for sales expenses, is pooled and invested in a portfolio of securities. The mutual fund shareholder, like the Flexible Fund investor, may redeem his interest at any time and receive in cash the value of his proportionate share of the underlying portfolio. The principal aim of the mutual fund shareholder, like that of the Flexible Fund participant, is to invest in the securities markets by entrusting his capital to the company's management with the expectation that its efforts will result in a profit to him.

An examination of respondent's own sales literature demonstrates quite vividly that the "Flexible Fund Annuity" is offered as a medium for investment in the stock market.[5] Thus, respondent's sales brochure (which is distributed to potential purchasers) describes the Fund as an "*opportunity* to share in the growth of our economy" (PX 3; JA II 11) and emphasizes the company's "full-time professional investment management" and its "investment policy" of investing "the major part [of the Fund] in com-

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[5] See *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 352-353, where this Court stated that in determining whether a particular document or offering is within the scope of the Securities Act, "[t]he test is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."

mon stocks" (PX 3; JA II 15). The brochure also discusses the "History of Common Stock Investments," which is graphically demonstrated with Dow-Jones Industrial Stock Averages and a diagram of "the rate at which money grows" (PX 3; JA II 16). Respondent's newspaper advertisements also emphasize "New Opportunity for Financial Growth" (PX 6; JA II 26). Its sales agents are equipped with flyers listing "FFA Investments," which highlight the diversification and quality of the investment portfolio and contain tables showing, for example, a 30-year accumulation totaling more than eight times the amount of the purchaser's payments into the Fund (PX 5; JA II 23, 25).

It is this opportunity to share in the growth of a portfolio of securities which distinguishes the Flexible Fund arrangement from a conventional annuity and which warrants the application of the securities laws. A conventional annuity is essentially a fixed-dollar obligation. The purchaser of such an annuity has a right to receive a fixed amount, and he is protected by a system of State insurance regulation designed to make certain that the insurance company will remain solvent and be able to meet such fixed obligations. Thus, traditional State insurance regulation of reserves and solvency provides meaningful protection to the holder of a conventional annuity, and it was presumably regarded by Congress as obviating the need for the type of protections afforded by the securities laws. The Flexible Fund participant, on the other hand, has an interest which fluctuates in accordance with the market performance of a port-

folio of securities. He has an opportunity to share in the growth of that portfolio and he bears the consequent investment risk. The historic functions of State insurance regulation have only slight relevance when applied to such an interest, while the disclosure and other protections of the securities laws are vital.

2. The courts below erred in concluding that the minimum guarantee provision of the contract in issue rendered it an exempt "insurance product." While it is true that this feature shifted a portion of the investment risk from the purchaser to respondent, it did not alter the essential nature of the transaction or remove the need for protecting investors through the disclosure and regulatory provisions of the securities laws. The guarantee actually accords an investor only the barest form of protection; at most he is assured that, over a long-term period, the value of his investment will not fall below the "net" amount he has paid into the Fund. But the guarantee gives him no yield or return on his investment during that time nor does it protect any interim appreciation in the value of his interest. An investor's interest in the Fund can ordinarily be expected to last 25 years,[6] and may continue for as long as 50 or 60 years.[7] During that period the accumulated value of his interest in the Fund may grow to several times the amount actually paid by him. He is afforded no protection by respondent against the gradual or sudden erosion of such growth; his only protection is a

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[6] See Brief for Appellee in the court of appeals, p. 2.

[7] PX 3; JA II 19.

"guarantee" that his "net" purchase payments will be refundable. And even as to this "guarantee" the court of appeals noted that respondent's own statistical studies (PX 17; JA II 111-113, JA I 64-73, 101) proved that "it is extremely unlikely that the Fund's investment experience will be so disastrous as to call the guarantee into effect" (pp. 20-21, *infra*). The disclosure and regulatory provisions of the 1933 and 1940 statutes were enacted to protect investors who might be subject to the risk of such losses as may occur here and not merely those who might suffer out-of-pocket losses.

Nor was the district court correct in concluding that the availability of a fixed annuity "which cannot be outlived" (JA I 106) at the contract's maturity rendered respondent's Fund contract an "insurance product." Respondent has simply attached a standard annuity to its open-end investment plan and given investors the option of purchasing that annuity with the fruits of the investment program. The "pay-out" portion of the "Flexible Fund Annuity" is clearly an "annuity contract" within the meaning of Section 3(a)(8) of the Securities Act of 1933, 15 U.S.C. 77c(a)(8), and the Commission has never contended otherwise. But that does not mean that the "pay-in" portion, which in every way other than the "minimum guarantee" resembles a mutual fund contract, can, by virtue of its combination with an "insurance product," be converted into an exempt "insurance contract."

3. The court of appeals' decision is particularly important to the administration of the federal securi-

ties laws because of the recent growth of the variable annuity business and the ease with which a seller of variable annuities can, under the decision below, avoid compliance with the 1933 and 1940 Acts.

The remarkable growth of the mutual fund industry in recent years, as witnessed by the fact that between the end of 1950 and the end of 1965 the assets of mutual funds grew from $2.5 billion to $35 billion and the number of mutual fund shareholders rose from 450,000 to 3.5 million,[8] has stimulated interest on the part of insurance companies and banks in offering to the public participations in a pool of equity securities as a medium of investment having the same primary economic function as a mutual fund. Insurance companies have done so through the sale of variable annuities. Their sale is now permitted in 29 States,[9] in a number of which the enactment of enabling statutes specifically authorizing their sale was necessary.[10] The growth of the variable annuity industry has been rapid. In the five-year period from the end of 1960 to the end of 1965, the assets of the variable contract accounts of annuity plans registered under the 1940 Act have in-

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[8] These are figures compiled by the Investment Company Institute covering its member companies. The asset figures appear in Wiesenberger, *Investment Companies* (1966 ed.), p. 20, and the shareholder figures appear in an Investment Company Institute publication, Investment Company News, June 1966, p. 4.

[9] *The Glow Gets Rosier for Variable Annuities,* Business Week, January 29, 1966, p. 76.

[10] *The Regulation of Variable Annuities—Pt. II,* Best's Insurance News—Life Edition, November 1965, pp. 52-56.

creased almost nine-fold, from $1,781,904 to $15,365,757.[11] Some of the nation's leading life insurance companies are entering the variable annuity field,[12] and, with respect to the type of variable plan involved in the instant case, it has recently been reported that in at least one State a number of the major companies have already filed contract forms covering the "flexible annuity." [13]

The effect of the decision below would be to permit insurance companies to sell shares in investment pools without complying with the statutes enacted by Congress for the protection of persons who purchase such shares. Almost any insurance company, including VALIC itself, could engage in the unregulated sale of such shares since it could easily add an option to take a fixed annuity at the maturity of the plan. The court of appeals candidly recognized (p. 21, *infra*) that there is no "substantial possibility" that respondent would have to make good on its guarantee,[14] so that this feature could also be readily added to any variable annuity. We submit that, contrary

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[11] One company which was in existence in 1960 did not register until 1963. If the assets of this company were included in the 1960 figure, the total for that year would be $2,436,181.

[12] *The Glow Gets Rosier for Variable Annuities, supra,* note 9.

[13] *The Variable Dollar Frontier Revisited,* Best's Insurance News—Life Edition, July 1966, pp. 14, 18.

[14] Presumably the Nebraska Insurance Commissioner would not have permitted the guarantee unless he also was satisfied that it would not result in the invasion of ordinary policyholders' surplus for the exclusive benefit of Flexible Fund participants.

to the view of the court of appeals, this Court's decision in *VALIC* does not sanction such a result. In any event, whether or not it does is an important question in the administration of the federal securities laws which this Court can and should resolve.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted.

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Solicitor General.

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AUGUST 1966.

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 19382

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

v.

UNITED BENEFIT LIFE INSURANCE COMPANY, APPELLEE

Appeal from the United States District Court for the District of Columbia

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Decided March 10, 1966

Mr. Walter P. North, Associate General Counsel, with whom *Mr. Philip A. Loomis, Jr.*, General Counsel, Securities and Exchange Commission, was on the brief, for appellant. *Mr. Robert L. McCloskey*, Attorney, Securities and Exchange Commission, also entered an appearance for appellant.

Mr. Daniel J. McCauley, Jr., of the bar of the Supreme Court of Pennsylvania, *pro hac vice*, by special leave of court, with whom *Mr. M. Joseph Stoutenburgh* was on the brief, for appellee.

Mr. Joseph B. Levin, with whom *Mr. Marc A. White* was on the brief, for Investment Company Institute and National Association of Securities Dealers, Inc., as, *amici curiae*, urging reversal.

Before BAZELON, *Chief Judge*, EDGERTON, *Senior Circuit Judge*, and BURGER, *Circuit Judge*.

BAZELON, *Chief Judge:* The basic issue in this case is whether the Flexible Fund Annuity (FFA) issued by appellee United Benefit Life Insurance Company (United) is subject to federal regulation under the Securities Act of 1933 and the Investment Company Act of 1940. The Securities and Exchange Commission sought injunctive relief in the District Court against United on the grounds that the FFA contract is an unregistered "security" within the definition of the 1933 Act [1] and that the separate account, which United created in connection with the FFA, is an unregistered "investment company" within the meaning of the 1940 Act.[2] The District Court ruled that the FFA was an "insurance product," exempted from regulation under both Acts.[3] This appeal followed.

The FFA contract is framed as a deferred annuity policy. The policyholder agrees to pay United a specified gross premium periodically—*i.e.*, once a month—for a certain number of years. These premiums, less deductions for expenses, are accumulated by United during this deferred period in a separate account, known as Flexible Fund A. Unlike a conventional annuity, however, United does not guarantee to ac-

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[1] 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(1) (1964).

[2] 54 Stat. 797 (1940) as amended, 15 U.S.C. § 80a-3 (1964).

[3] The Securities Act of 1933 contains an exemption for,

> "Any insurance or endowment policy or annuity contract or optional annuity contract . . . ." 15 U.S.C. § 77c(a) (8) (1964).

The District Court did not explicitly address itself to the Investment Company Act, but implicit in its decision is a finding that the Flexible Fund fell within the exemption of that Act for "any bank or insurance company . . . ." 15 U.S.C. § 80a-3 (c) (3) (1964).

cumulate net premiums at a specified rate of interest. Instead, United promises that the annuitant will be credited with a proportionate share of the profits which have resulted from the investment and reinvestment of the money in the Flexible Fund. In addition, United guarantees that at least 100 per cent of the net premiums wlil stand to the account of the annuitant throughout the deferred period if the investment experience of the Fund is unprofitable.[4] Cash surrender values equal to the accumulated value or minimum guarantee of the policy, and death benefits equal to the accumulated value or total gross premiums paid, whichever are higher, are also provided during the deferred period. At the maturity date specified in the policy, the annuitant is given the option of withdrawing the accumulated value of his policy in cash or of applying this value to a fixed annuity at rates prescribed in the initial contract. These rates are based upon a guaranteed 2½ per cent interest factor during the pay-out period, and once United begins payments to the annuitant the value of his policy is fixed; the profits made by the Fund are no longer accumulated in favor of the annuitant.

The result in this case, as both parties recognize, is controlled by the Supreme Court's recent decision in the *VALIC* case.[5] At issue in *VALIC* was a variable annuity policy which did not guarantee a fixed monetary value for the annuity either in the deferred or pay-out periods; its value at all times depended directly upon the investment experience of a pool of

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[4] This assumes that the deferred period is ten years or longer. If the deferred period is less than ten years, United only guarantees a percentage of the net premiums, ranging from 50 per cent in the first year to 90 percent in the ninth year.

[5] *SEC* v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

securities, and the annuitant was, in effect, a direct participant in that pool. The question was whether this variable annuity was a "security" within the meaning of the 1933 and 1940 Acts or a "contract of insurance," which would be exempt from the Acts by their own terms, as well as by the provisions of the McCarran-Ferguson Act.[6] The majority of the Court found that the issuing company had assumed the mortality and expense risks usually associated with insurance. However, since the company did not guarantee a fixed monetary value for the policy, it placed "all of the investment risk on the annuitant, none on the company." Because the concept of insurance required "some investment risk-taking on the part of the company," the Court concluded that the variable annuity was not "insurance" and hence was subject to federal regulation.

In a concurring opinion, Mr. Justice Brennan explained in greater detail why the factor of investment risk was determinative. He pointed out that the purpose of the federal regulatory scheme had only minimal relevance to conventional insurance and annuity policies, which assumed the investment risk by creating fixed monetary obligations, and that state regulation of reserves and solvency offered truly meaningful protection to the policyholder. Mr. Justice Brennan reasoned that since the variable annuity in *VALIC* did not include substantial fixed dollar guarantees, federal regulation was quite relevant to the variable annuity contract, while state regulation was not; he therefore found the contract a "security," subject to the 1933 and 1940 Acts. In sum, both the majority and concurring opinions implicitly held that a company must bear a substantial part of

[6] 59 Stat. 33 (1945), as amended, 15 U.S.C. § 1011 (1964).

the investment risk associated with the contract, as well as the mortality and expense risks, in order to qualify its products as "insurance."

In most respects the FFA and the traditional deferred annuity are identical. Both guarantee interest on principal during the pay-out period; both assume all mortality and expense risks throughout the term of the contract; and both provide death benefits and cash surrender values.[7] The only meaningful difference between the FFA and the conventional deferred annuity is that the FFA does not guarantee interest on the accumulation of net premiums during the deferred period, but instead promises 100 per cent of net premiums plus a share in any profits made by the investment and reinvestment of the money in the Flexible Fund.

The SEC would minimize the similarities between the FFA and the deferred annuity first by asserting jurisdiction only over the deferred portion of the contract. The SEC then contends that the "investment risk" referred to in *VALIC* is the risk of not earning interest on the principal sum invested and that a contract is not "insurance" unless interest as well as principal is guaranteed. In support of this position the SEC emphasizes the extent to which the fortunes of the annuitant depend upon the investment policies and experience of the Fund and argues that the court should not treat the minimum guarantee of 100 per cent of net premiums as a substantial assumption of investment risk because it is extremely unlikely that

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[7] For a general description of the conventional deferred annuity see, *e.g.*, HUEBNER & BLACK, LIFE INSURANCE 104-16, 311-22, 329-30, 332-34 (6th ed. 1964) [hereinafter cited as HUEBNER & BLACK]; MEHR & OSLER, MODERN LIFE INSURANCE 79-103, 531-47 (3rd ed. 1961) [hereinafter cited as MEHR & OSLER].

the Fund's investment experience will be so disastrous as to call the guarantee into effect.

We note initially that adoption of the SEC's position that interest must be guaranteed during the deferred, as well as the pay-out, period would restrict annuity policies essentially to their current form. This result would contravene the explicit warning of the Supreme Court in *VALIC* where all nine Justices counseled against freezing the concept of annuity into a single pattern and argued that development and growth of insurance concepts should be allowed.[8] We also think that the SEC has misconceived the concept of "investment risk," as it is used in *VALIC*, by focusing on the likelihood of United's having to make good on its guarantee. Presumably no insurance company will undertake a guarantee in any policy if there is a substantial possibility that it will have to resort to surplus to satisfy that obligation.[9] Instead of denoting the company's risk, we think the concept refers to the annuitant's risk of losing money—principal, as well as anticipated earnings on principal—over the course of the investment period. By guaranteeing principal—100 per cent of net premiums—United has assumed a substantial part of this risk during the deferred period of the contract. Were the annuitant to invest on his own in the stock market, or even in so-called "safe" securities like bonds and

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[8] 357 U.S. at 68, 71, 75-76, 100-01.

[9] If an insurance company guarantees 2 per cent or 3 per cent interest, it does so only after it has made extensive studies which demonstrate to its satisfaction that there is no substantial probability that the funds associaed with the policy will fail to earn this amount over the duration of the contract. See, *e.g.*, HUEBNER & BLACK 296-300, 346-47, 388-90; MEHR & OSLER 590-93, 599.

mortgages, he would not have this guarantee, and his principal would never be absolutely secure.[10]

Finally, we reject the SEC's basic premise that the contract should be fragmented and the risk during the deferred period only should be considered. United's guarantee of principal and 2½ per cent interest during the pay-out period is a very substantial assumption of investment risk, which should not be ignored. Indeed, the *VALIC* opinions, as well as common sense, indicate that a challenged policy should be viewed as a whole in order to test its amenability to federal regulation. All told, United has assumed not only a substantial part, but by far the major part, of the investment risk over the duration of the entire policy.[11] The obligations of United under the FFA,

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[10] The SEC also urges that so long as the contract allows the annuitant any direct participation in the investment experience of the company, the policy must be subject to the federal regulatory scheme. This argument ignores completely the language and logic of *VALIC*, which contemplated a test based on the substantiality of the investment risk assumed by the company. See 359 U.S. at 71-73, 85, 89. A related objection to this argument is the effect that it would have upon the participating annuity, which the SEC concedes is exempt from federal regulation. The participating annuity clearly provides, and is intended to provide, that the annuitant will participate directly, even if minimally, in the investment experience of the company. See, *e.g.*, HUEBNER & BLACK 387-98; MEHR & OSLER 598-605; 614-20.

[11] The substantiality of the investment risk which United assumes in the FFA is even more apparent when that policy is compared with a participating annuity. In the latter, the interest factor during the deferred period is deliberately set quite low so as to assure dividends; and while dividends are in theory discretionary, in practical terms they must be declared regularly or the company will lose too much business. In effect, a participating policy promises, in part, a smaller interest guarantee in return for the opportunity to share in

unlike those of the variable annuity, are stated, in large part, in terms of guaranteed dollar amounts; there is a substantial and meaningful "floor" to the FFA policy. We therefore conclude that the FFA is an "insurance" contract and as such beyond the scope of federal regulation under the 1933 and 1940 Acts.[12] The judgment of the District Court is

Affirmed.

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greater interest when that is earned. See, *e.g.*, HUEBNER & BLACK 387-402; MEHR & OSLER 598-605, 614-20. For this reason the FFA can be regarded as an extension or development of the concept of participating insurance.

[12] The SEC finally contends that the case should be reversed because of the trial court's rulings on admission of evidence. Whether or not these rulings were correct, we don't think they affected "substantial justice." FED.R.CIV.P. 61.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

SEPTEMBER TERM, 1965

No. 19,382

[Filed March 10, 1966.]

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

v.

UNITED BENEFIT LIFE INSURANCE COMPANY, APPELLEE

Appeal from the United States District Court for the District of Columbia

Before: Bazelon, Chief Judge, Edgerton, Senior Circuit Judge, and Burger, Circuit Judge.

JUDGMENT

This cause came on to be heard on the record on appeal from the United States District Court for the District of Columbia, and was argued by counsel.

On consideration whereof It is ordered and adjudged by this Court that the judgment of the District Court appealed from in this cause be, and it is hereby, affirmed.

Per Chief Judge Bazelon

Dated: March 10, 1966

APPENDIX C

STATUTES INVOLVED

1. The Securities Act of 1933 (48 Stat. 74, as amended, 15 U.S.C. 77a, *et seq.*) provides in pertinent part:

DEFINITIONS

Sec. 2. When used in this title, unless the context otherwise requires—

(1) the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * * *

EXEMPTED SECURITIES

Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * *

(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commission-

er, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

* * * *

2. The Investment Company Act of 1940 (54 Stat. 789, 15 U.S.C. 80a-1, *et seq.*) provides in pertinent part:

GENERAL DEFINITIONS

Sec. 2(a) When used in this title, unless the context otherwise requires—

* * * *

(8) "Company" means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

* * * *

(17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

* * * *

(21) "Issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.

* * * *

(27) "Person" means a natural person or a company.

* * * *

DEFINITION OF INVESTMENT COMPANY

Sec. 3.(a) When used in this title, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

* * * *

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

* * * *

(c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

* * * *

(3) Any bank or insurance company; * * *

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